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Memorandum for: RECORD

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West European Banks: Risks to the United States

The United States has a great deal to be concerned about regarding Western Europe's banking industry. The size of the Euromarket was over $2,000 billion at the end of March this year and has grown by a staggering 100 percent in the last four years, and more than six-fold since 1973. Banking is one of Europe's largest industries comprising well over 12,000 banks which operate some 130,000 offices. The 30 biggest banks employ about one million people. Seven of the top ten banks in the world -- ranked by assets -- are headquartered in Europe, and the ten largest banks in Western Europe are located in France (4), West Germany (3) and the UK (3).

The Problem: Information, Standards, and Secrecy

Unfortunately it is difficult to systematically assess the financial soundness of banks in the euromarket system for a variety of reasons. Banking regulations are not uniform across countries and banks themselves as part of the natural course of doing business and keeping client trust shroud a good part of their operations in secrecy; not an uncommon practice in many industries but one that poses a certain risk for the banking industry and its role as financial intermediary between primary lenders and borrowers.

Problems with banks and euromarket operations are usually dealt with on an ad hoc basis, and even a crisis such as Banco Ambrosiano precipitates only stop-gap measures. The debt crisis

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is starting to change attitudes among central bankers, however, and has encouraged a greater amount of cooperation. While necessity and survival of the international financial system have brought many resources to bear on the current problems, risks to the system remain large.

Banks in the euromarket system face two kinds of fundamental risks: (1) liquidity and solvency and (2) confidence. The first takes in the bulk of the problems now facing the banks dealing with the debt crisis. How well these issues are dealth with by central and commercial bankers affects the second and potentially more damaging of the two types of risks.

Sources of weakness in the euromarket system which are wrapped-up in the liquidity/solvency problems and can affect the United States include:

- The lack of information about bank- and country-exposure to problem borrowers. The inability to adequately evaluate the quality of bank assets is the greatest peril to the international banking system. The lack of consolidated balance sheet reporting and accounting differences among countries significantly raises the economic cost of information.
- High (i.e. weaker than in US banks) asset to capital ratios in West European banks, particularly the nationalized banks in France and Austria.

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- The susceptability of the interbank market to changes in, and tiering of, deposits which can seriously affect a bank's ability to fund assets.
- The participation of Arab banks in the unregulated euromarket system: these banks are not part of the G-10 group that formulated the 1975 concordat and its 1983 reformation which sets out principles governing the supervision of banks' foreign establishments by parent and host authorities.
- The inability of banks to adequately evaluate debt trends in prospective borrowers. This is particularly true for non-syndicated medium-term borrowing and all short-term borrowing.

Recipe for a Crisis

These structural problems make the system vulnerable to a liquidity crisis which could also induce solvency problems. The major countries' central banks are committed to deal with liquidity problems in the system and let solvency problems work their way out through reorganization and takeovers. The line between liquidity and solvency is not clearly drawn and what the central banks are prepared to do in a crisis is also not clear.

This lack of information about banks and borrowers, and what central banks are prepared to do, are the initial ingredients for a general confidence crisis, which by its very nature would shut down the international banking system. A confidence crisis is

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unlikely in that it would probably take a combination of international events that would cause investors/depositors to switch from financial to real assets, leaving the banks with a funding problem that could not be solved by central bank intervention even as lender of last resort. A hypothetical example might go like this: Argentina fails to service its debt in a de facto moratorium...Brazil and a few other major debtor countries reject a weakened IMF's austerity plans...INF deployment in Western Europe sets off serious riots...the Iran-Iraqi War heats up, drawing in Saudi Arabia, stopping all oil shipments from the Middle-East to the Western industrial countries...and two major banks -- one in the United States and one in Europe -- close their doors. The chain of events would shatter confidence in financial assets, and through a domino effect, paralyze the banking system.

Policy Shifts

West European banks appear to be strengthening their views that the Latin American debt situation is a US not a European banking problem. Citing lack of interest on the part of US banks in the Polish rescheduling, and an obvious desire to reduce future losses, many European banks are not willing to increase their exposure in Latin America. Moreover, interbank lines of credit to banks which are heavily exposed in Latin America have been reduced. Swiss banks, for example, are not making any new loans to Latin America and have intensified their flight into

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quality assets, particularly in the US. Commercial banks in the UK have not always followed the Bank of England's encouragement on rescheduling issues and has prompted the UK authorities to become more insistent.

Official policy actions now under consideration in some developed countries are also causing concern among commercial bankers. Despite encouragement to commercial banks from Swiss National Bank President Leutweiler to keep the credit lines open to problem debtor countries, the Swiss Banking Commission is considering imposing a 30 percent loan-loss reserve on any new loans made to problem debtor countries. This requirement would significantly raise the cost of lending. In another case, the Japanese Ministry of Finance is haggling with commercial banks over making loan-loss reserves a tax writeoff. At the same time, the US House version of the IMF legislation requires an unspecified percentage of new loans to problem debtor countries be set aside in loan-loss reserves. While contacts in other parts of the US Government have indicated to this Agency that this will not likely be a part of the final bill, taken with the considerations in the other countries, it could tend to make banks even more cautious about lending to LDCs.

The Outlook

The risks posed to West European banks, and all banks for that matter, are greater in the short-term than in the longer-run. The present structural weaknesses of the system, the

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volalitity of interbank lines of credit, divergence of commercial banks' attitudes toward the debt problem, an IMF under financial strain, and the perception that government policies may not be uniform all help to keep the liquidity risk facing the banking system very high. The economic and political inability of the LDC's to hit targets outlined in their austerity programs will add further stress to the system. Any crisis requiring immediate action on the part of West European governments and central banks would by necessity involve the US Government and Federal Reserve.

Bank failures will continue to dot the financial pages in the press and central bankers will work behind the scenes to salvage other institutions. So long as problems remain manageable, many West European banks are in a better position than their US counterparts to weather loan losses. Both West German and Swiss banks have hidden reserves which can be used to absorb bad loans without visibly affecting profits in any one year; the size of this cushion is unknown, however. Acceptance banks in the UK have the backing of the Bank of England and nationalized banks in France and Austria supposedly have the backing of their respective governments.

In the longer run, time and coordinated action can work to improve the situation and the structure of the system. Economic recovery in the industrialized economies will improve earnings for the LDC's. Work at the OECD and the EC to standardize banks' balance sheets and expand data collection will improve the flow

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of information to the market place. Further steps to make available more information to all participants would reduce confusion, permit better risk assessments, and generally correct the information problem endemic in the financial sector. Full disclosure by all banks of liability and asset exposure by various categories would be a self-correcting step to many of the problems.

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